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The Obama Administration's Report on "Reforming America's Housing Finance Market": Implications for Fannie Mae and Freddie Mac

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Summary

In February 2011, the Obama Administration released a report, "Reforming America's Housing Finance Market," setting out several options for the future of housing finance. In the past, the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac have played a crucial role in government support for the mortgage market. In 2008, however, both firms were taken over by the government and have received government life support since then. Fannie and Freddie continue to provide funds for mortgage lending, at a time when private capital has largely exited the market and not yet returned, but the expense to the government has been high: through the end of 2010, the Treasury has contributed $90.2 billion to Fannie and $63.7 billion to Freddie.

The Administration's report argues that Fannie and Freddie's failures expose basic flaws in the GSE model. Poor regulation, excessive risk-taking, and an implicit government guarantee of Fannie and Freddie debt contributed to a situation in which GSE profits went to private management and shareholders, but losses fell to the taxpayers. The Administration proposes to shrink Fannie and Freddie's role in housing markets as private capital returns. No specific timetable is set out in the report, but Treasury Secretary Timothy Geithner has estimated that the process of winding down Fannie and Freddie may take five to seven years.

The Administration proposes to raise the fees Fannie and Freddie charge for guaranteeing mortgage debt, limit the types of mortgages they can buy, and reduce the size of their investment portfolios. These steps can occur without congressional action—the effect would be to remove the GSEs' competitive advantages and allow private firms to compete on a more equal footing.

For the long-term, the report sets out three options: (1) a private system of housing finance, with government intervention only to support homeownership among specific groups, such as veterans or low-income families; (2) a private system with a federal backstop that would only operate in a crisis; and (3) a system of regulated private mortgage insurers backed by a federal reinsurance system, with premiums set high enough that taxpayers would bear losses only after significant amounts of private capital had been wiped out. In general, option 1 implies less risk for taxpayers, but more expensive or less available mortgage credit. Option 3 would provide the most support to the broad mortgage market, but would expose taxpayers to more risk and also have more potential to distort market incentives and private investment decisions.

Other proposals would lie on either end of the continuum represented by the Administration's three options. H.R. 1182 (Representative Hensarling) seeks to stem taxpayer losses by setting a two-year limit for the conservatorships of Fannie Mae and Freddie Mac and providing conditions for the continued operation of the firms or for the dissolution of the GSEs if they are judged to be not financially viable.

Proposals from the Mortgage Bankers Association and the Center for American Progress envision a more active federal role in the housing market, with new government-chartered entities taking on some of Fannie and Freddie's functions, but with additional regulation and safeguards. In short, in reforming the GSEs, Congress faces a trade-off between placing the taxpayer at risk to downturns in the mortgage market and reducing that risk, which could make mortgage credit less available and affordable to American households.

For a broader discussion of GSE reform, see CRS Report R40800, *GSEs and the Government's Role in Housing Finance: Issues for the 112th Congress*, by N. Eric Weiss.

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Background

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs) that have played a central role in mortgage finance. They provide a secondary market for home mortgages—buying mortgages from the original lenders, packaging them into bonds backed by homeowners' interest and principal payments (a process known as "securitization"), and selling these mortgage-backed securities (MBS) to bond investors with a guarantee that interest and principal will be paid on time. Currently, the value of mortgages purchased, securitized, and guaranteed by Fannie and Freddie exceeds $5 trillion, about half of all U.S. single-family residential mortgages. In addition, Fannie and Freddie own about $1.5 trillion in mortgages and MBS, which they hold in their investment portfolios.

A healthy secondary market ensures the availability of funds for mortgage borrowing. The source of credit is no longer the local banking industry, which is subject to periodic, cyclical contractions that reduce its ability to lend, but rather the global bond market. Banks are more willing to make mortgage loans if they can sell them into the secondary market rather than bear the risks of long-term lending.[1] It is widely accepted that Fannie and Freddie's operations have made mortgage credit more accessible and affordable.

Prior to the financial crisis, there was also a large private securitization market. "Private-label" MBS securitized mortgage loans that Fannie and Freddie's charters prohibited them from purchasing;[2] between 2002 and 2007, private issuers sold more than $3 trillion in MBS.[3] In 2008, that market came to an abrupt halt. Holders of many private-label MBS suffered severe losses as defaults rose and the value of the homes that served as collateral for the underlying mortgages fell. New MBS issues fell dramatically—to only $5.4 billion in 2010.[4]

The downturn in the housing market that crippled the private MBS market was also ruinous for Fannie and Freddie. As defaults and foreclosures rose, income from mortgage assets held or securitized diminished, leaving the two firms unable to meet the debt obligations they had incurred to purchase mortgages and MBS in the first place. By September 2008, it was clear that both Fannie and Freddie were insolvent, and the government stepped in to place both firms under conservatorship. As a result, Fannie and Freddie's regulator, the Federal Housing Finance Agency (FHFA), now exercises complete control over their operations.[5]

The alternative to conservatorship—to let the firms fail—appeared to pose unacceptable risks to the financial system, which was in deep crisis, and to the housing market. If Fannie and Freddie had ceased operations, mortgage securitization would have dried up, and it is likely that few banks would have been willing to risk making new mortgage loans. Liquidation of Fannie and Freddie would have entailed dumping mortgage assets on the market at a time when many institutions were struggling to cope with losses from MBS and mortgages already on their balance

[1] A 30-year, fixed-rate mortgage is highly risky for a bank, even if the borrower does not default. If interest rates rise, the lender is stuck with a below-market return. If rates fall, homebuyers refinance into the lower rate. In addition, regulators require banks and other depository institutions to hold capital commensurate with the risks.

[2] These included subprime mortgages and "jumbo loans" that exceeded size limits imposed by statute—see CRS Report RS 22172, *The Conforming Loan Limit*, by Eric Weiss and Mark Jickling.

[3] Securities Industry and Financial Markets Association, "U.S. Mortgage-Related Issuance," available at http://www.sifma.org/research/statistics.aspx.

[4] Ibid.

[5] See CRS Report RS22950, *Fannie Mae and Freddie Mac in Conservatorship*, by Mark Jickling.

sheets. Prices would almost certainly have plunged, driving up the cost to new mortgage borrowers.[6]

Under conservatorship, Fannie and Freddie have continued their MBS issuance and have not significantly reduced the size of their portfolios. Even though both firms are operating at a loss to the government, they are essentially propping up the housing market. Because private capital has not yet returned to the market, over 90% of new mortgages are purchased, guaranteed, and securitized by Fannie, Freddie, or full-faith-and-credit government agencies, such as the Federal Housing Administration (FHA) and the Government National Mortgage Association (Ginnie Mae).[7]

Continued support for Fannie and Freddie has been costly. Under the terms of the conservatorship, the Treasury has agreed to inject capital into both firms (in the form of preferred-stock purchases) as necessary to prevent either firm from having a negative net worth. As of the fourth quarter of 2010, these purchases have totaled $90.2 billion for Fannie Mae and $63.7 billion for Freddie Mac.[8]

While there are many views on how the housing market should function in the future, and what the government's role should be, there appears to be little support for returning Fannie and Freddie to their pre-conservatorship status. The idea that shareholder-owned firms should use their government-sponsored status to boost profits for the benefit of shareholders, management, and employees in good times, only to shift losses to the taxpayers during bad times, is now generally considered unsatisfactory. In February 2011, the Obama Administration released a report that set out several options for the future of housing finance.

Fannie and Freddie in the Obama Administration's Report

"Reforming America's Housing Finance Market: A Report to Congress," the Obama Administration's reform proposal, identifies four principal reasons why Fannie and Freddie failed.[9]

1. Their for-profit structure undermined their public mission, which required them to promote stability in the housing market, as well as provide liquidity to the market. To maximize profits, both firms took on excessive risks. Because of weak regulation, they were not required to hold adequate capital against those risks.
2. Their "government-sponsored" status conferred unfair competitive advantages. Market participants viewed Fannie and Freddie securities as backed by the government, despite the lack of a formal full-faith-and-credit guarantee. As a

[6] Bond prices and interest rates move in opposite directions. Thus, if existing mortgages and MBS are available at a deep discount, new mortgages will have to carry a higher interest rate to equal the yield of older assets on sale in the market.

[7] U.S. Department of the Treasury and Department of Housing and Urban Development, "Reforming America's Housing Finance Market: A Report to Congress," February 2011, p. 12, available at http://www.treasury.gov/initiatives/Documents/Reforming%20America's%20Housing%20Finance%20Market.pdf.

[8] Federal Housing Finance Agency, "Capital Under Conservatorship," available at http://www.fhfa.gov/Default.aspx?Page=78.

[9] Reforming America's Housing Finance Market, pp. 8-9.

result, the firms were able to borrow at lower rates and they were able to operate with more leverage and less capital than their private competitors. The growth of their investment portfolios was an aggressive strategy to maximize the monetary value of the implicit government guarantee.

3. Capital standards were unfair and inadequate. Low capital requirements allowed Fannie and Freddie to charge artificially low fees to guarantee mortgages, effectively giving them a monopoly in the conventional mortgage market.[10]
4. Regulation was weak and ineffective. Before the FHFA, Fannie and Freddie's regulator did not have authority to constrain excessive risk taking. Aggressive lobbying by both firms prevented efforts to impose stricter regulation.

Rather than address the identified problems through specific legislative or regulatory proposals, the Administration proposes to wind down Fannie and Freddie's participation in the housing market. This would be done by removing their competitive advantages and further restricting the kinds of mortgages that they are allowed to purchase. To accomplish this, the Administration sets out five specific mechanisms:

1. Require Fannie and Freddie to raise their guarantee fees to what those fees would be if they were held to the same capital standards as private banks or financial institutions. This would allow private firms to compete on more even terms, and should reduce Fannie and Freddie's market share over time.
2. Encourage Fannie and Freddie to obtain credit loss protection from private insurers.
3. Reduce the size of investment portfolios, which had the effect of allowing Fannie and Freddie to operate as hedge funds whose losses would fall upon taxpayers. Under the terms of the Treasury support agreement, Fannie and Freddie should reduce the size of their portfolios by 10% per year.
4. Allow the current conforming loan limits to expire. During the crisis, Congress raised the ceiling on the size of mortgages Fannie and Freddie are allowed to purchase. If Congress allows these emergency increases to expire as scheduled on October 1, 2011, the loan limit will fall from $729,750 to $625,500 in "high-cost" housing areas (and lower elsewhere).
5. Gradually increase the size of the required down payment on mortgages purchased by the two firms. The Administration proposes to increase the minimum down payment to 10%, which would reduce the number of mortgages that Fannie and Freddie are allowed to buy.

None of the above proposals requires congressional action. The Administration's report does not set out specific timetables, but notes that reducing Fannie and Freddie's role depends on the return of private capital to the housing market. In congressional testimony, Treasury Secretary Timothy Geithner has estimated that the process may take five to seven years.[11]

The Administration's report does not discuss the ultimate disposition of Fannie Mae and Freddie Mac. The logic of the proposals suggests that the GSEs should eventually become equal competitors with Wall Street firms in the secondary mortgage market, without any significant

[10] As noted above, private MBS issuance was generally limited to subprime and jumbo mortgages, because private issuers could not compete with Fannie and Freddie in the markets where the GSEs were allowed to operate.

[11] Response to a question from Representative Hensarling, at House Committee on Financial Services Hearing, "Mortgage Finance Reform: An Examination of the Obama Administration's Report to Congress," 112th Cong., 1st sess., March 1, 2011. (From *Congressional Quarterly* transcript.)

advantages conferred by government charters. This presumes that market participants will no longer view the GSE charters as conferring an implicit federal guarantee and that investors will evaluate the riskiness of Fannie and Freddie securities on the same basis as private securities. To revoke Fannie and Freddie's charters and fully privatize the two firms would require an act of Congress.

Broad Options for the Housing Market

The Administration's report sets out three long-range scenarios for the future government role in the housing market. The options involve tradeoffs among four factors:

- improving access to mortgage credit (which may expose the government to risk);
- providing incentives for housing investment (which may divert resources from other productive uses);
- protecting taxpayer from loss (which may conflict with the two factors above); and
- financial and economic stability (government responses to crises may create moral hazard and encourage excessive private risk taking).

Table 1 below presents the basic components of the Administration's three options. None of the three envisions Fannie and Freddie remaining in their current roles.

Table 1. The Obama Administration's Options for Housing Finance Reform

Option	Government Role	Advantages	Drawbacks
(1) Privatized System	Mortgage assistance for narrowly targeted groups of borrowers (FHA, USDA, VA)	No taxpayer exposure to general market risk, and no distortion of private investment decisions.	Government support in a housing crisis would be limited to ad hoc regulatory responses or emergency legislation. Without a guarantee, mortgage rates would likely rise to cover risks.
(2) Privatized System with a Government Guarantee in Crisis	In addition to (1), government would guarantee mortgages, but would price the guarantee so high that it would only be used in the absence of private capital—during a crisis.	Allows government to mitigate a housing crisis without taking on the costs associated with a government guarantee in normal economic conditions.	Operational challenge of designing a structure that does very little under normal conditions but can scale up rapidly during a crisis. Little aid to mortgage liquidity and access during normal times.
(3) Privatized System with Government Reinsurance	In addition to (1), the government would offer reinsurance to a group of regulated, private mortgage insurers. Premiums would protect taxpayers against loss, which would occur only after the private insurers' capital was wiped out.	Explicit guarantee is more likely to lower mortgage costs than (1) or (2). Ensures that private capital provides protection for taxpayers against loss, except perhaps in extreme market conditions.	If the private mortgage insurers are not regulated properly, this option could create moral hazard and encourage market participants to take undue risks. Increased flow of investment into housing could divert capital from more productive uses.

Source: U.S. Department of the Treasury and Department of Housing and Urban Development, "Reforming America's Housing Finance Market: A Report to Congress," February 2011, pp. 27-30.

Roughly speaking, options one through three represent an increasing government presence in housing finance. Option 1 insulates the government from losses during a crisis, unless one assumes that government will respond to political pressure and in some way cover private losses rather than let the mortgage market come to a standstill. The absence of an explicit guarantee shifts risk to the private sector, and one would expect mortgage lenders, guarantors, and insurers to charge more to cover that risk or to reduce the supply of mortgage credit to borrowers perceived as risky.

Option 3 exposes government to more risk than the first two, and has more potential to distort private economic decisions than option 1 or option 2. The regulated mortgage insurers to whom the government would provide mortgage reinsurance may be subject to some of the same conflicts and incentive problems that afflicted Fannie and Freddie. At the same time, the presence of an explicit government backstop should encourage investors to buy MBS, thus providing a more dependable flow of funds into the mortgage market.

Other Options

Other proposals for housing finance reform have taken different approaches, but they may be categorized according to the continuum of tradeoffs among the Administration's three options. That is, the basic policy choice is between the extent to which taxpayers are protected from loss and the amount of support and liquidity government provides to the mortgage market. (For a broader survey of options for restructuring Fannie and Freddie, see CRS Report R40800, *GSEs and the Government's Role in Housing Finance: Issues for the 112th Congress*, by N. Eric Weiss.)

Privatizing Fannie Mae and Freddie Mac

There have been calls to stem taxpayer losses by bringing Treasury support for Fannie and Freddie to a speedier end—a frequent criticism of the Dodd-Frank Act was that it failed to address the GSE problem. Legislation before the 112th Congress—H.R. 1182 (Representative Hensarling)—proposes to set a term certain for ending the conservatorship and government assistance. Introducing the bill, Representative Hensarling noted that "the GSEs are on track to be the nation's biggest bailout, more than AIG and GM and all the big banks combined. It's time to enact fundamental reform of Fannie and Freddie before these companies go from 'too big to fail' to 'too late to fix.'"[12]

Under H.R. 1182, the conservatorship would end two years after enactment. If the FHFA determines at that point that either Fannie or Freddie is financially viable, the firm(s) will continue to operate under new regulations, and the GSE charter would be set to expire in three years. If either GSE did not appear to be financially viable, the FHFA would place the enterprise into receivership and liquidate it. This raises the prospect that bondholders might not be paid in full, as is normally the case in a commercial bankruptcy. The FHFA would be authorized to extend the two-year period by six months if necessary to avoid an adverse effect on the housing markets.

If a GSE came out of conservatorship, it would face new requirements and restrictions. The value of assets in the investment portfolio would have to shrink to no more than $250 billion within three years of the end of conservatorship. Minimum capital requirements would be increased, as would the guarantee fees charged by Fannie and Freddie. The emergency increases in the conforming loan limit would be repealed, the GSEs would be prohibited from purchasing mortgages that exceeded the median area home price, and minimum down payments would be imposed.[13] The affordable housing goals that set targets for GSE purchases of medium- and low-income mortgages would also be repealed.

In addition, several current features of the GSE charter—exemption from state and local taxation and exemption from certain registration and disclosure provisions of federal securities laws—would be repealed. In summary, at the end of the three years following the end of conservatorship, there would be little substantive difference between Fannie or Freddie and private mortgage securitizers, and their government charters would expire. In the interim, because they would arguably be subject to more stringent regulation that private MBS issuers, their GSE status might constitute a competitive disadvantage.

Proponents of a quick end to Fannie and Freddie argue that uncertainty about their ultimate fate is slowing the return of private capital into the secondary market. On the other hand, if assistance to Fannie and Freddie ends before private capital can take up the slack, the result could be a further shock to the housing market. It is worth noting that several provisions of H.R. 1182—including expiration of the conforming loan limits, raising the guarantee fees, and higher down payments—are supported by the Administration's report. Under the Administration's plan, the end-game for

[12] "Hensarling Re-Introduces Legislation to End Taxpayer Funded Bailout of Fannie Mae and Freddie Mac," press release, March 18, 2011, at http://hensarling.house.gov/news/press-releases/2011/03/hensarling-re-introduces-legislation-to-end-taxpayer-funded-bailout-of-fannie-mae-and-freddie-mac.shtml.

[13] The minimum down payment would be 5% in the first year, 7.5% in the second year, and 10% in the third.

Fannie and Freddie might be generally similar to what H.R. 1182 proposes, but would take effect over a longer time frame.

New-Look GSEs

There are other proposals that would have the government play a larger role in housing finance than any of the options set forth by the Administration. For example, the Mortgage Bankers Association (MBA) and the Center for American Progress (CAP) have published position papers that would preserve more of the functions currently performed by Fannie and Freddie in government-chartered or regulated entities.[14]

These two proposals, though different in the details, essentially would take the regulated, private mortgage insurers in the Administration's third option and make them operate more like Fannie and Freddie. Under the CAP proposal, "chartered mortgage institutions" would guarantee MBS that met certain quality standards. These institutions would be required to purchase all qualifying mortgages that lenders wished to sell. In addition, these entities would be subject to housing goals, that is, they would be required to provide support in specific areas of concern, such as small multi-family, rural, and moderate-income housing, or housing in natural disaster areas.

Under the MBA proposal, a small number of privately owned "mortgage creditor-guarantor entities" would provide credit risk insurance to securitizations of "core" mortgages—loans with characteristics that presented low risk of default. The risks these entities could take would be highly regulated, and they would not be allowed to hold large investment portfolios of mortgage assets.

Like the Administration's third option, both the CAP and MBA proposals include an explicit federal guarantee for qualifying MBS, which would be either securitizations of low-risk "core" mortgages or mortgages that carried a government guarantee (such as those backed by the FHA or the Department of Veterans Affairs). The MBA suggests that the insurance premiums could provide a source of funds to support affordable housing programs.

One interpretation of these proposals is that they make an implicit case that the basic GSE concept remains sound despite Fannie and Freddie's collapse, provided that certain excesses are eliminated and regulation improved. There is some support for this view in the Administration's report:

> The losses that the federal government has covered at Fannie Mae and Freddie Mac... are virtually all attributable to bad loans that those firms took on during the height of the housing bubble. Over the last two years, Fannie Mae and Freddie Mac have implemented stricter underwriting standards and increased their pricing. As a result, the new loans being guaranteed by Fannie Mae and Freddie Mac today are of much higher quality than in the past and are unlikely to pose a significant risk of loss to taxpayers.[15]

However, given the size of the losses, the Administration does not appear willing to expose the taxpayer to the pre-crisis level of mortgage risk, even though that risk—if managed properly over the long-term—could make mortgage credit more available and affordable to American households. This is arguably the basic trade-off facing Congress as it considers GSE reform.

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[14] Mortgage Bankers Association, "MBA's Recommendations for the Future Government Role in the Core Secondary Mortgage Market," August 2009, at http://www.mbaa.org/files/News/InternalResource/70212_RecommendationsfortheFutureGovernmentRoleintheCoreSecondaryMortgageMarket.pdf, and Center for American Progress, "A Responsible Market for Housing Finance: A Progressive Plan for Residential Mortgages," January 2011, at http://www.americanprogress.org/issues/2011/01/responsible_market.html.

[15] "Reforming America's Housing Finance Market," p. 23.

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